

Letter of Findings Number: 04-20110493
Sales/Use Tax
For Tax Years 2008 - 2010

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ISSUE

I. Sales/Use Tax--Various Equipment.

Authority: IC § 6-8.1-5-1(c); IC § 6-2.5-2-1; IC § 6-2.5-5 et seq.; IC § 6-2.5-3-2; IC § 6-2.5-5-6; [45 IAC 2.2-5-14](#); [45 IAC 2.2-5-8](#); Letter of Findings 04-20050438 (August 11, 2006); Letter of Findings 04-20100485 (January 13, 2011).

Taxpayer protests the assessment of use tax for various items and equipment.

STATEMENT OF FACTS

Taxpayer makes custom flexible packaging and custom signs. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit for the tax years 2008 through 2010. As a result of the audit, the Department issued proposed assessments for sales and use tax. Taxpayer protested the proposed assessment. An administrative hearing was conducted and this Letter of Findings ("LOF") results. Further facts will be supplied as required.

I. Sales/Use Tax--Various Equipment.

DISCUSSION

At the outset, the Department notes that under IC § 6-8.1-5-1(c): "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Pursuant to the Indiana Code, a sales tax ("gross retail tax") is imposed on retail transactions made in Indiana unless a valid exemption is applicable. IC § 6-2.5-2-1; IC § 6-2.5-5 et seq. Also, a complementary excise tax "known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a).

In its protest letter, Taxpayer protested that several items "should be exempt from sales tax." Those protested items are dealt with below.

(1) Labels:

Regarding labels, the Audit Report stated that:

Assessments are being made on labels which are placed on cardboard boxes used for shipping. The labels are both shipping labels and "Caution" and "Do Not Double Stack" labels. The labels are not affixed on the product being produced, but placed on the cardboard boxes which are used to protect the product during shipping.

Taxpayer describes the labels thusly:

These are labels that we use in the production of our products. They are placed on the outside of our shipping cartons to notify the various carriers that the pallets cannot be double stacked in the trailers. This is a precaution that we must take to protect the plastic bags we produce during shipping.

IC § 6-2.5-5-6 states:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.

And [45 IAC 2.2-5-14](#) states in relevant part:

(d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral part is exempt from tax. "Incorporated as a material or an integral part into tangible personal property for sale by such purchaser" means:

(1) That the material must be physically incorporated into and become a component of the finished product;

(2) The material must constitute a material or an integral part of the finished product; and

(3) The tangible personal property must be produced for sale by the purchaser.

(Emphasis added).

In the Taxpayer's case, the labels are not incorporated as a material part of the property. The labels are used on the shipping cartons, not the product itself. Therefore the labels do not meet the requirements of IC § 6-2.5-5-6 and [45 IAC 2.2-5-14](#)(d). Taxpayer's protest of this issue is denied.

(2) Software Maintenance:

The Audit Report states that "taxpayer was not charged sales or use tax on annual software maintenance agreements" and then cites to Sales Tax Information Bulletin 2. Given that Taxpayer's audit period was from 2008 to 2010, the version of Sales Tax Information Bulletin 2 that the Auditor relied upon was not in effect for the audit period. This is because the revised 2006 version was not published in the Indiana Register until August 4, 2010, and was therefore not in effect for dates at issue. However, in Letter of Findings 04-20050438 (August 11, 2006), 20061101 Ind. Reg. 045060474NRA, the Department addressed the question of whether "Software Maintenance Agreements" were subject to sales tax. In that Letter of Findings the Department found that these agreements were subject to sales tax on a "prospective basis" as follows:

There is no regulation that sets out the department's position regarding the application of sales and use tax to optional warranties. The department first issued Sales Tax Information Bulletin [] 2 concerning Optional Warranties... on May 2, 1983. In that Information Bulletin, the department explained that if there was a possibility that no tangible personal property would be transferred with the warranty, then there was no certainty that there would be a retail sale and the sales and related use tax did not apply. This position was restated in the revised Sales Tax Division Information Bulletins issued in August 1991, November 2000, and May 2002. Each of the revisions restated the general rule. In the May 2002 revision, it was stated "[o]ptional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax." Each of the revisions also gave a specific example concerning computer software situations. The examples stated that sales and use tax would apply to the sale of an optional warranty or maintenance agreement in the software situation only if there was a guarantee of the transfer of tangible personal property (updates) pursuant to the agreement.

Computer technology and use has evolved since the issuance of the first Sales Tax Information Bulletin [] 2 on May 2, 1983. Almost all software optional warranties and software maintenance agreements sold today include the automatic provision of updates-sometimes on a day-by-day or week-by-week basis. Purchasers of these agreements have a reasonable expectation that they will receive the updates whether or not the actual contract couches the provision of updates as "optional." The substance of the agreements is that tangible personal property in the form of software updates will be provided no matter what the language of the contract says. The department determines tax consequences by construing the substance of the agreement over the form. *Wholesalers, Inc. v. Indiana Department of State Revenue*, 597 N.E.2d 1339 (Ind. Tax 1992). In the case of software maintenance agreements or optional warranties, it is clear that the parties presume that tangible personal property in the form of updates will be transferred. Therefore, the department will construe software maintenance agreements and optional agreements as presumed to be subject to the sales and use tax. A taxpayer could rebut this presumption by demonstrating that no updates were actually received pursuant to a particular maintenance agreement or optional warranty. (Emphasis added).

Letter of Findings 04-20050438 was published in the Indiana Register in 2006. Since it was published in 2006, it was in effect during the audit time period of the Taxpayer. As the Department explained in Letter of Findings 04-20050438, software maintenance agreements are considered taxable unless a taxpayer rebuts that presumption by demonstrating that no updates were actually received pursuant to a particular maintenance agreement or optional warranty.

With that in mind, we can now turn to Taxpayer's argument. Taxpayer states:

This is our annual service agreement provided by our software company to provide IT help with any problems that would arise during the year. As stated in our original protest letter, no tangible personal property is supplied to [Taxpayer].

The copy of the "Service Level Agreement" provided by Taxpayer states in pertinent part: "Warranty and Maintenance customers are entitled to receive free basic classroom training, software updates, telephone and web support for the [] System Software licensed directly from [Company S]." Emphasis added.

Taxpayer states that it did not receive updates, but Taxpayer did not provide any documentation to that effect. Taxpayer has not demonstrated that no updates were actually received pursuant to the software maintenance agreement. Thus, Taxpayer has failed to meet its burden of proof under IC § 6-8.1-5-1(c). Taxpayer's protest of this issue is denied.

(3) Materials to Replace Lights:

Next, Taxpayer argues that "[m]aterials to replace lights on the shop floor" should be exempt. Taxpayer states that "the lights are 30 ft. above the floor and require specialized equipment to allow access to the lights when the bulbs need to be replaced." Taxpayer states that the lights "illuminate the work area below."

As the Audit Report notes, [45 IAC 2.2-5-8\(c\)](#) states:

(4) Because of the lack of an essential and integral relationship with the integrated production system in Example (1), the following types of equipment are not exempt:

(A) Equipment and furnishings located in the administrative offices of the plant.

(B) Clothing or other equipment furnished to workers that is used primarily for the workers' comfort and convenience if the workers are able to participate in the production process without it.

(C) An electrical distribution system, including electrical switchgear, transformers, cables, and related equipment used to supply electricity to the administrative office building.

(D) A boiler used to produce steam for general heating in the plant or administrative office building.

(E) A fire extinguisher hung on a wall inside the plant.

(F) Ceiling lights for general illumination in the plant area.

(G) Equipment used to remove raw materials from storage prior to introduction into the production process or to move finished products from the last step of production. (Emphasis added).

As [45 IAC 2.2-5-8\(c\)\(4\)\(F\)](#) shows, ceiling lights for illumination in the plant area are taxable. Therefore, materials used to replace the lights are taxable. Taxpayer's protest of this issue is denied.

(4) Floor Mats:

Taxpayer states that the floor mats are "used by our pressmen as they work by the printing press." At the hearing, Taxpayer stated the employees that work on the press stand on the floor mats. The Department finds that the floor mats are taxable under [45 IAC 2.2-5-8\(c\)\(4\)\(B\)](#). Taxpayer's protest is thus denied.

(5) Computers, Monitors, and Printers:

Taxpayer at the hearing stated that the computers are used to capture information for various jobs. In subsequent correspondence to the Department, Taxpayer describes the "computers, monitors and printers" as "used in the production process to print out job specifics and allow the production workers to log in and out of individual jobs. This tracks the work time and is also used as a time clock."

[45 IAC 2.2-5-8\(c\)\(6\)](#) states: "A computer is used to process accounting, personnel, and sales data. The computer is taxable because its use in this manner is not an integral and essential part of the integrated production process." Thus Taxpayer's use of the computer "to log in and out of individual jobs" for tracking work time is taxable. Regarding any other potential uses of the computer, Taxpayer failed to develop its argument regarding how the capture of information by the computer is exempt.

Taxpayer's protest of this issue is denied.

(6) Floor Fans:

Taxpayer argued at the hearing that the floor fans are used to dry the screens that have been cleaned with water in the screen printing operation. In follow-up correspondence, Taxpayer stated the "floor fans are used to dry the screens used in production in our screen printing operation." [45 IAC 2.2-5-8\(c\)](#) states:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

And further, [45 IAC 2.2-5-8\(h\)](#) states in part:

(h) Maintenance and replacement equipment.

(1) Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

The floor fans are not directly used in the direct production process. Furthermore, the floor fans are akin to maintenance equipment found in [45 IAC 2.2-5-8\(h\)](#). Taxpayer's protest of this issue is denied.

(7) Baler:

In its original protest letter, Taxpayer listed as an item being protested "[m]aterials to repair bailer [sic]" and stated "Bailer [sic] is used in production." At the hearing, Taxpayer stated that it gets plastic and cardboard, that Taxpayer bales this scrap material and then sells it.

The Audit Report notes:

The taxpayer is being assessed on an invoice for materials used to fix their bailer [sic]. The bailer [sic] is used to bundle the scrap that comes from cutting the materials to fit the customer's requirements. The bailer [sic] is used as a post production activity after the main manufacturing process is conducted. The bailer [sic] is not directly used in direct production of the scrap and does not have an immediate effect of the scrap that was produced.

[45 IAC 2.2-5-8\(c\)](#), in pertinent part, states:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property. (Emphasis added).

Taxpayer states that it sells the scrap, but the Department notes that the scrap is not a "product" manufactured by Taxpayer. The scrap is a by-product of Taxpayer's process—in other words the scrap is not an item that is manufactured by the transformation of component raw materials into a distinct product. In Letter of Findings 04-20100485 (January 13, 2011), 20110323 Ind. Reg. 045110137NRA, which dealt with a baler issue involving a different taxpayer, the Department stated:

Taxpayer did not substantially change or transform the scrap cardboard paper. Taxpayer simply repackaged the scrap cardboard paper in bales after its manufacturing process is completed and its finished products were produced. As provided by Rotation Products and North Cent. Industries, a taxpayer's activities must

result in something new in order to qualify for the exemption found in IC § 6-2.5-5-3(b). Taxpayer's activities result in repackaging of the same scrap cardboard paper, from unbaled to baled. There is nothing new produced.

In the present case, Taxpayer's protest is denied for the reasons stated above.

FINDING

Taxpayer is denied regarding all the protested items.

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